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Notes to contributors

The editors welcome contributions to the Briefing Paper, Feature Article and Economic Perspective sections. Material submitted should be of interest to a predominantly Scottish readership and written in a style intelligible to a non-specialist audience. Footnotes and references should conform to recent issues of the Commentary. Contributions should be typed and two copies submitted to the Editor.

Articles accepted for publication *must* be supplied on 3.5 inch or 5.25 inch disks in either WordPerfect or ASCII format (together with a Press Notice for distribution to the media).

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QUARTERLY ECONOMIC COMMENTARY

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OUTLOOK AND APPRAISAL

The latest UK indicators hint of a mild recovery beginning to take hold after nine successive quarters of negative growth. However, the recession in Scotland deepened in the second quarter and third/fourth quarter evidence offers little comfort for output and employment prospects.

The Scottish economy contracted sharply in the second quarter, again showing the difficulty of forecasting growth at the regional level. The short term forecast model had been predicting a small upturn from the first quarter of 1992. As it happens, the index of production and construction fell by 3.4% over the quarter. The major areas of decline were in investment goods (-5.1%), construction (-5.1%), intermediate goods (-2.2%) and Electrical and Instrument Engineering (-10%) although the latter makes up only 15% of production goods. Compared to the UK the quarterly performance of Scottish industries is considerably inferior. UK Electrical & Instrument Engineering and Investment Goods grew by 1.0% and 0.6% while Intermediate Goods and Construction fell by 1.2% and 0.8% respectively.

When one compares annualized growth rates - the change between the four quarters up to 1992q2 and the preceding four quarters up to 1992q1 - it still seems that Scotland is faring better than the whole of the UK. Production and Construction in Scotland remained unchanged while its UK counterpart contracted by 2.2%. Production fell by 0.4% in Scotland and by 1.1% in the UK while manufacturing industry declined by 0.9% compared to a UK 3.0% fall.

It is obvious from the figures that the Scottish recession only began in the first half of this year because the annual growth rates of the four Scottish industries mentioned above with the largest falls in production were significantly above the UK and, in fact, only intermediate goods production fell over the period. On an annualized basis Investment goods rose by 4.4% (UK -5.0%), Construction by 1.7% (UK -7.3%), Electrical and Instrument Engineering by 8.0% (UK -10.0%) and Intermediate goods production fell by 8.0% (UK -3.0%). In addition, production of Consumer Goods, which fell by -2.0% over the quarter declined by 3.7% over the year compared to the 1.7% recorded for the UK as a whole.

The October 92 edition of the Scottish Chambers Business Survey, which hurdled ***Black Wednesday***, reports the heaviest fall in business optimism in Scotland since the survey began. Optimism, orders & sales, capacity utilisation and employment all showed worsening downward trends in the third quarter.

In the third quarter, according to the Halifax Building Society, 'All Buyers' house prices rose by 0.3% compared to the 5.6% fall recorded in the UK property market. In fact, Scotland was the only region which registered positive growth reflecting the less severe debt overhang which we have repeatedly referred to in past Commentaries.

Since the beginning of 1992 the Scottish male unemployment count has risen by 8.3% from a rate of 12% to 13%. The UK count has risen by 12.8% from a rate of 12% to 13.6%. Female unemployment in Scotland has fared even better. The count has risen by only 4.1% from a rate of 5% to 5.3% whereas in the UK the rate has risen to 5.5% from 5%, a rise in the count of 11%. Total claimant unemployment has risen by 7.3% in Scotland and 12.4% in the UK.

In October 1992 the seasonally adjusted level of total claimant unemployment rose by 1000 leaving the rate unchanged at 9.7% of the workforce. This rise does not reveal the fact that female unemployment actually fell again by 200. In contrast the UK rate rose by 0.2% points to stand at 10.1% and confirms the view, once again, that up until the middle of this year the Scottish economy had fared better than the country as a whole.

The UK Economy

The general picture tends to confirm the view that the UK economy may be about to emerge from this protracted recession. The provisional estimate of third-quarter output-based Gross Domestic Product remained unchanged over the quarter. In contrast, when oil and gas are excluded non-oil GDP actually fell by 0.3%. This is the first time since 1991q4 that total GDP has been non-negative and is the rationale for our optimism.

On the whole the latest UK indicators are favourable to this view. Retail sales volume and value rose by 0.1% and 3.9% in October. Industrial production rose by 0.4% in September, although this was down by 0.1% on the same time last year. Moreover, the trend is upward from its low point in June and July. Consumer and Intermediate Goods production both rose by 0.6% in September, the latter at least appearing to follow an upward trend over the past five months.

Financial and inflationary indicators add to this story. M0, M2 and M4 all grew in October by 2.4%, 3.7% and 5.4% respectively. M4 growth was 0.6% above September's figure. Bank lending grew by an impressive £5106m in October after falling by £846m in September, although the rise was not attributed to consumption demand. Average earnings grew by a mere 4.9% in September their lowest level for over 12 years.

As usual, we find that Britain's export performance needs attention. The Current Account of the Balance of Payments slipped further into the red and currently stands at £9743bn for the first ten months of 1992. The figure for the year 1992 is expected to top £13bn.

This large monthly deficit is probably due to what is termed the J-curve response of imports to a devaluation. When the home currency is devalued, the value of imports rises and exports become cheaper and more competitive. In the short term, this inflates the value of imports and pushes the current account further into deficit. In the medium term more exports are sold to foreign customers, because they are now more competitive, and the current account deficit begins to shrink.

Even though the fall in the value of Sterling will reduce imports in the medium term our inability to satisfy demand even in recession leads to worries of repressed inflation and the re-occurrence of another boom-bust episode not unlike 1987/88. Our medium-term worries are exacerbated by the 2.5% increase in raw materials costs in October, only the second and the largest monthly rise this year. The two indicators may suggest that any further interest rate reductions will simple stoke up medium-term inflationary pressures.

Even more frustrating, though, is the perpetual rise in the number of unemployed in Britain. Unemployment has risen by 317,000 this year alone and according to the OECD the Standardised internationally comparable rate now stands at roughly 10.1% of the workforce, the highest rate in the G7. This is surpassed by only Portugal, Ireland and Spain within the European Community. In other words, the cost of reducing inflation is very high in terms of the lost human capital of the workforce, especially in the case of those who have been out of work for more than 52 weeks. These are the long term unemployed, whose skills quickly depreciate in value and efficiency, who, in a large number of cases are never again required to contribute to the value added of their national economy.

UK Trade and the ERM aftermath

Since Black Wednesday the value of Sterling has depreciated by some 14% against the Deutschmark and by 25% against the dollar. This provides improved opportunities for UK exporters in an ever increasingly competitive world market, especially for those industries whose goods are invoiced in dollars. Given the likelihood of a successful end to the Uruguay Round of GATT trade talks, the UK should be in a better position to tackle its embarrassingly poor trading performance.

However, euphoria following withdrawal from the ERM should be contained since approximately one third of total UK exports are sold to the Hard-ERM countries of Germany, France, Belgium and the Netherlands. In order to maintain the benefits from this competitive advantage UK trade remains dependent on the survival of the ERM, a factor which is looking somewhat unlikely at the time of writing. The recent devaluation of the Escudo was forced by the devaluation of its main competitor, the Spanish Peseta, and there is no reason to believe that this would not happen throughout the European Community if the ERM were to break up, ie if the *Francfort* is breached.

Prospects for the Scottish Economy

Analysing the prospects for the Scottish economy is troublesome now that the structure of the UK economy has changed in the wake of financial deregulation and freer credit facilities. While it would seem that recovery is beginning in the southern half of the UK the time lag before Scotland emerges is an uncertainty and likely to produce large forecasting errors.

On the positive side, as we have already noted in the last Commentary, the devaluation will increase the Sterling export profits of oil producers and computer companies, whose products are invoiced in dollars. Since Office Machinery and Data Processing is Scotland's major export commodity the devaluation will certainly be to Scotland's benefit. In addition, the fiscal stimulus provided by the Autumn Statement will have beneficial effects in a Construction industry whose output index is only now beginning to show the depression that analysts have been aware of for some time.

On the negative side we have bad news coming from the product market and a probable acceleration in unemployment. Since the SCBS survey has a good track record the pessimistic production and construction figures seem ominous for short term Scottish economic performance. The effect of higher long bond yields will certainly dampen any switch into Investment Goods, which make up over one quarter of the Scottish production industry. In addition the cost of raw materials in the UK rose sharply in October, raising fears that more expensive imported raw materials may lead to cost push inflation sooner than we originally imagined.

In the labour market we have recently seen 3,500 job losses in the Royal Bank of Scotland and 1,100 in the Post Office, both allegedly the result of restructuring in the face of technical change. In addition there are fears that the Ministry of Defence may yet decide to close the

Rosyth shipyard, with the obvious deleterious effects on Scottish political and economic confidence.

The problem for the Scottish economy is that in our view a sustained recovery relies on the healthy growth of Scottish exports and not consumers' expenditure. However, we do not feel that Scotland has a large enough base of companies to export on the scale required to rapidly pull us out of recession. This view is founded on the belief that the Scottish individual is traditionally more risk averse and less entrepreneurial than the southern equivalent, with the implication that the Scottish economy is less dynamic and unlikely to recover as quickly. Therefore, in our view, unemployment will continue rising for longer than in the south of the UK and respective unemployment rates will begin to diverge once again. Consequently, due to the UK having the highest OECD standardised rate of unemployment in the G7 we are particularly worried about the effects of the high UK unemployment cost of reducing inflation, or *Sacrifice Ratio*. This has already and may once again lead to an wasteful and *Hysteretic* labour market.

Hysteresis is the term used describe the phenomenon whereby after every recession there appears to be a rise in the level of unemployment required to produce stable and low inflation.

The policies being discussed by EC members comprise co-ordinated efforts to boost 'Active' employment measures, ie Training and Education programmes for the unemployed, in an effort to reduce the wasteful loss of resources. On this issue we find that the British government is out of step with the rest of the Community, as in the case of a recovery package for the faltering EC economy, in its tailoring of legislation to the demands of the market. The UK labour market has the least employment legislation, the lowest levels of employee protection (note the abolition of the Wages Councils), and yet has one of the highest rates of unemployment in the developed world. It is therefore quite likely that reducing future inflation will further increase UK and Scottish unemployment, as the layoff costs to employers are much smaller than their European counterparts. A fuller and more detailed account of the UK labour markets can be found in the *Regional Review*.

The FAI short term model forecast at first glance does not seem to reflect this pessimism. We have produced a central forecast, using information up to and including 1992q2, for 1992/1991 of -1.4% growth in the Production and Construction industries. We do feel, however, that the actual outcome will tend towards a contraction of between 2.0% and 2.5% over the year given that the SCBS/CBI evidence suggests that the second quarter will be followed by another six months of contraction.

In the medium term the outlook for Scotland and the UK depends on the ability of the Government to control public finances, control inflation and solve Britain's chronic unemployment problem. It may happen that when the UK Housing market recovers the lessons of the late 1980s will have been learnt. If so the inflationary pressures may be contained and +2% growth resume in the 1994 - 96 period. If not, then we may have to go through all this again as the PSBR rockets toward £60bn and skill shortages lower productivity levels and international competitiveness. Hopefully we can look forward to the former.

8 December 1992